

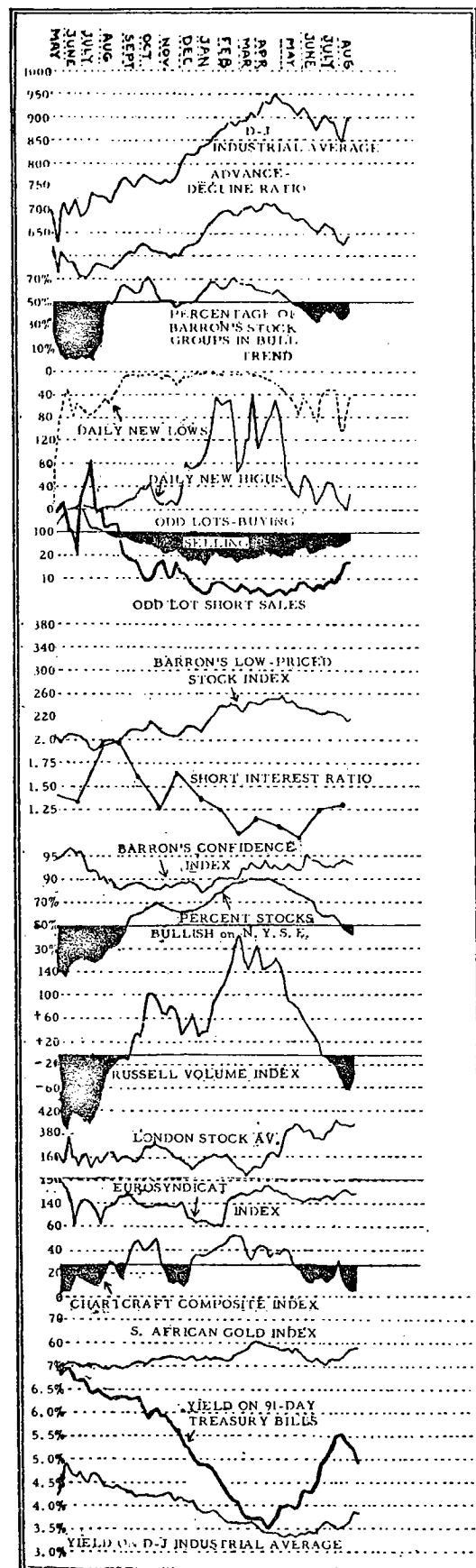
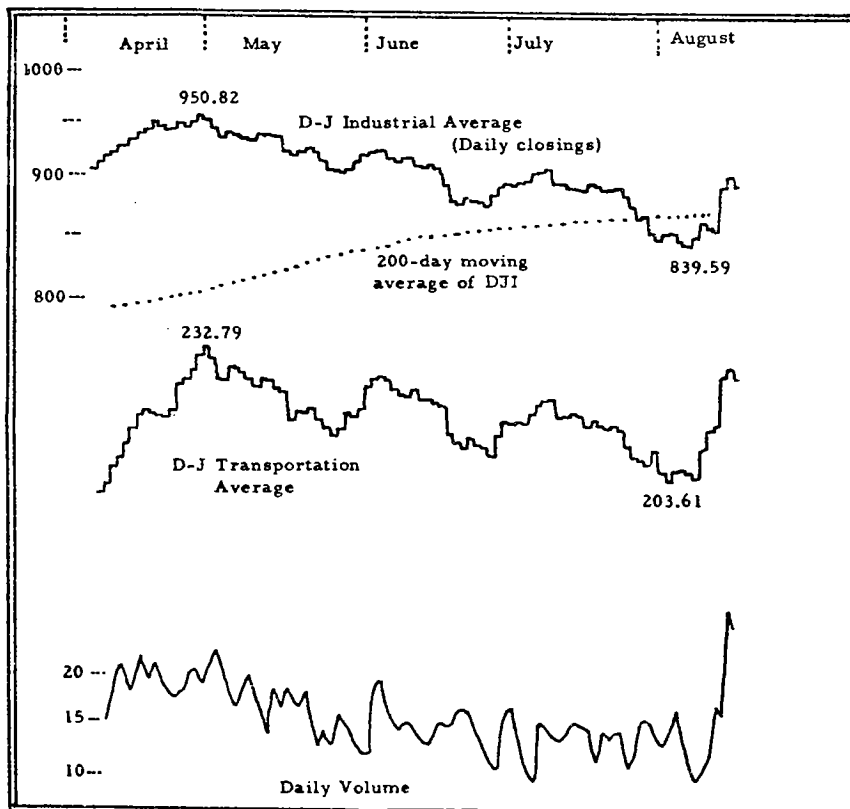
August 20, 1971

Letter 504

"WORDS IMPLIED BUT NEVER SPOKEN DEPT." You nasty little nations who piled up dollars while thinking (or hoping) they were as good as gold, you can choke on them. No more gold for dollars. And here's another tid-bit, a 10% surcharge on most goods shipped into the U.S. Want to get rid of the surcharge? Well, for a starter, revalue your currency upward so that U.S. goods are cheaper overseas and foreign goods are more expensive here. Make yourself less competitive, and maybe we'll consider removing the 10% surcharge. That should hold all you international speculators and monetary manipulators for a while.

PERSPECTIVE: I do not want to go into a long rehash of the measures which President Nixon put into effect with his speech of August 15. I do want to say, however, that I believe that the speech and the measures put forth completely skirt the real issues. Nowhere did the President mention that the American economy and the dollar are in trouble. Nowhere did Mr. Nixon address himself to the real problems, and it seemed to me that the main idea was to make it appear the wage and price controls would solve the inflation issue, and that embargoing gold would strike fear into the heart of "the international speculators" who have given the good old American dollar such a hard time these many years.

What I see ahead is a long series of controls, controls to augment controls, and boards and commissions to administer controls. It will be an exercise in economic agony and frustration. As to the 10% tax of foreign goods, I see this as the probable beginning of a world-wide trade war (which will occur with little publicity in the beginning) as nation after nation retaliates for the unfair and arbitrary U.S. trade barriers. I see the dollar embarking on a further sea of



Page 2 troubles as it floats with no fixed value on international markets. This type of "rudderless" currency will constitute the worst possible background for foreign trade. Tie this in with rising trade wars and you have the seeds of a world depression.

With the removal of the promise to redeem in gold, the dollar toppled from its throne as a reserve currency. When a foreign nation holds dollars today, what do they actually hold? Nobody knows, except that the dollar is a floating piece of paper that must find a new market price with the dawn of each new day. It is essential for a reserve currency to possess an intrinsic value, a hard core which both friends and enemies, cohorts and competitors can trust. As a currency goes, so goes the nation — is an axiom which has held up for centuries. If this holds true, the U.S. is in for a rude awakening over the months ahead.

Ultimately, Europe will have to come up with a stable, gold-backed currency of its own, one which people can trust and do business with. I would imagine that progress will be made on a European currency in late-September when the IMF meets.

Finally, tax stimuli and credits have a positive effect during a bull market when the economy and the markets are healthy. Now, with factories running on 73% of capacity and the consumer running scared, I doubt that the 10% tax credit will have any great effect. And when the public is scared and confused, income tax credits will not boost spending. Frightened people put extra money in the bank, and this is what I expect in the year ahead.

In other words, I see the Nixon measures as a series of manipulations which will neither help the dollar nor reduce inflationary forces in any fundamental way. The history of controls indicates that controls beget more controls, and this is what I foresee as the U.S. fights the markets of the world and the law of supply and demand in a frenzied effort to hold itself up by its own inflationary bootstraps.

THE MARKET: Robert Rhea observed (and I have often repeated this thesis) that the market's first reaction to unexpected or shocking news is usually the opposite of the direction which it will shortly take.

The market had declined from the period of April through August. As the news of business deterioration, inflation and "stag-flation" became common knowledge, the decline on Wall Street assumed even broader characteristics. Then as 30% wage increases became the order of the day, it was apparent that Washington had become a bastion of "do nothing-ism", and pressure increasingly centered on the Administration. How long could the economy "be allowed" to drift and sink? On Wall Street, any certainty is preferable to any uncertainty.

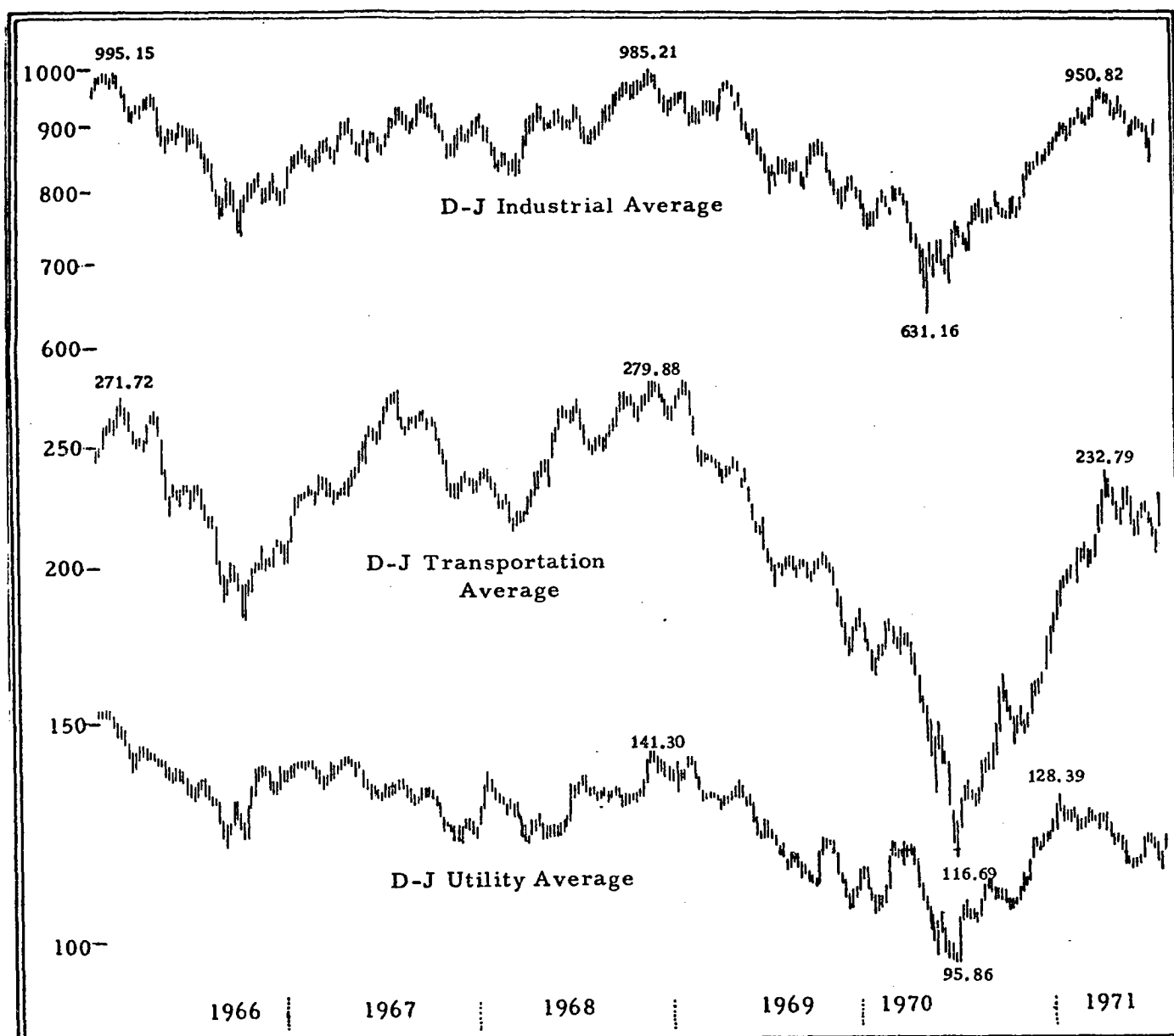
When the President's measures were broadcast to the nation Sunday night (Aug. 15), the air was cleared. The President had scraped together most of the recent economic suggestions of the Democrats and thrown in a few of his own. Whatever else it meant, he was "doing something".

The rally of Monday (August 16) made history as the Dow rose a record 32.93 points (actually, 3.84%) to the tune of a record 31.7 million shares. From all reports, the public entered the market en masse on August 16, and prices were marked up to such an extraordinary extent that all three Dow Jones common stock Averages showed upside "gaps" on the charts (see Wall Street Journal, Aug. 17). The gap of 18.18 points in Industrials between the high of Friday (Aug. 13) and the low of Monday (Aug. 16) is, I believe, the biggest gap in the history of the N.Y.S.E., and it may require the passage of many weeks or months before we understand the full meaning of this extraordinary phenomenon. One thing is sure — it required tremendous enthusiasm to produce those gaps in the Averages, and as far as I am concerned, great enthusiasm during a primary bear market is almost always a dangerous thing. The rally continued on Tuesday with a 10.95 gain in the Dow.

At this point it should be remembered that the Administration has now "shot its wad". Its first game plan failed, its second game plan failed. The Fed has flooded the nation with the biggest boost in the money supply since World War II. The economic package of August 15 represents the emptying of the "magic box". All the rabbits are out of the hat. A friend asked me what would happen if the economy fails to respond to the President's latest surprises. "In that case," I replied, "the bear market will do what it has intended to do all along. We will see a full correction (both in the stock market and the economy) of a quarter century of speculation, boom, waste and economic mis-management".

My friend asked, "And do you think that the Administration has the answer in their latest program?" My reply, I must admit, was a short one: "No".

BIG PICTURE: The Page 3 chart is a tracing of my weekly chart of the three D-J common stock Averages. The chart is drawn to semi-logarithmic (or ratio) proportions, and this means that all movements up or down are shown in percentages.



For instance, a rise from 100 to 150 on the Utility Average will cover the same vertical distance as a rise from 600 to 900 on the Industrial Average.

A quick glance will show us that the real mover of the past three years was the Transportation Average, both on the downside during 1969-70 and on the upside during 1970-71. The Transportation Average was also the worst performer during the 1969-70 smash, having lost about 58% of its total value.

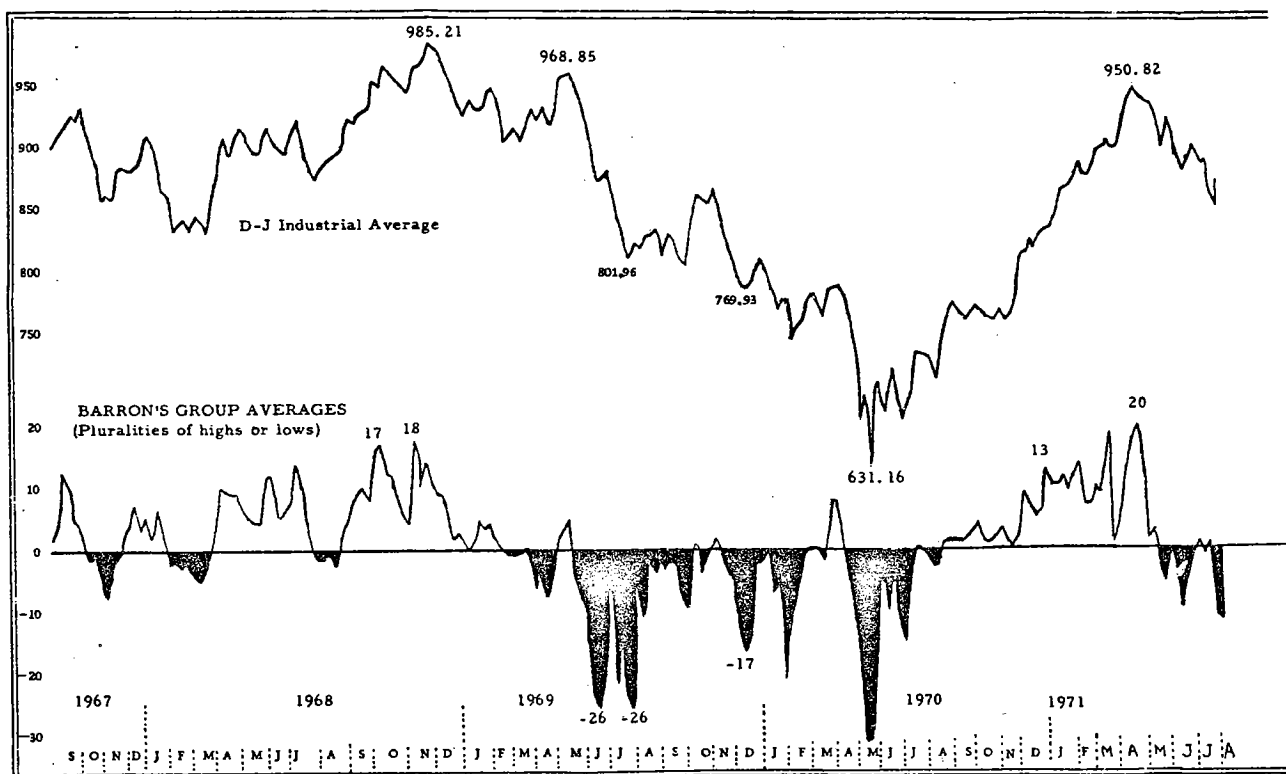
On the recovery of 1970-71 the Industrial Average recouped about 90% of its 354 point loss sustained during 1969-70. Even with the decline since April, 1971, Industrials are still well above the halfway mark of the 1970-71 advance.

The Transports also did well, having recovered 71% of their 1969-70 losses during the 1970-71 advance. Here again, even with the decline since April, 1971, the Transports have held better than half their gains (the halfway point is 174).

Finally, we come to the Utility Average, an Average which has increasingly acted as a bellwether for the market. From the 1968 peak to the 1970 low Utilities lost an astounding 33% of their total value (astounding because Utilities are supposed to be "defensive stocks"). On the 1970-71 recovery the Utility Average recouped 72% of its 1968-70 losses. But note that the Utility Average recorded its high for 1971 on January 19, three months before the other two Averages recorded their own highs. On August 10 the Utilities struck a low for 1971 at 112.15. Incredibly, the halfway mark of the 1970-71 Utility recovery (95.86 to 128.39) is 112.12, and this means that at the August 10 low the Utility Average was 3¢ above the halfway recovery level!

To me, the Utility Average is the "weak sister" of the three Averages, and I feel it will be important to see whether the Utilities can hold above the 112.12 mark or whether the next decline will succeed in wiping out over half of the recovery movement in the Utility sector (thereby taking the Utility Average below 112.12).

all, however, I feel that this chart can be studied as the profile of a typical, yet deceptive, long-term primary bear market. Note how the Transports in 1968 bettered their 1966 high, although Industrials refused to confirm. Then we see the result of that flagrant non-confirmation, the collapse of 1969-70. Next, we note the violent, inflation-fed recovery of 1970-71 with the Utilities topping out in January and the Industrials and Transports topping in April. Finally, we have the "surprising" summer decline of 1971, and currently the attempt at a recovery. Although the present recovery could be more forceful than anything seen since April, I feel the next major movement will be a reassertion of the primary bear forces and a breaking of the July-August 1971 lows as the Averages head back towards the bear market depths of 1970. This could begin later this fall or even during early 1972.



GROUPS: One of the technical studies which I have discussed here is the plurality of new highs or lows (weekly) as tabulated from statistics in Barron's. Each week Barron's carries 35 stock groups (I do not use the golds which tend to be counter-cyclical), and any group touching a new high for the year is marked with an "H" while any new low is marked "L". If, for instance, a week produces 10 new group highs and 1 new low, I mark the chart plus 9 or a plurality of 9 for the week.

If you study the chart you will note that this procedure provides an excellent picture of the direction and the amount of buying power or selling pressure on the market. For instance, selling pressure was big during mid-1969, selling pressure was still there but not as vicious during late-1969 and early-1970. By May, 1970, selling pressure was climatic.

Glancing at 1971 we see that buying power and groups touching new highs increased all through the first quarter. The week ending April 24 brought in the peak of strength with a plurality of plus 20. Four weeks later the index plunged to zero, and by May the index was in the minus column as the number of groups touching new lows surpassed those hitting new highs.

The first week in August produced a plurality of minus 12, which indicated the most selling pressure since June, 1970. From here on, the extent of deterioration (if any) may be measured by minus pluralities with minus 12 standing as the lowest reading of the year. On the upside, all progress must be measured against the plus 20 plurality of April 24.

QUESTIONS & ANSWERS: Q....What should I do with my gold shares?

A....Hold them. With the demise of the dollar, the great fortunes of the world will turn increasingly towards hard currencies and gold as the only real repository of value. The stable nations of the Free World do not want to follow the inflationary course of the U.S. and they will therefore move towards creating their own gold-backed currency and probably re-institute the gold standard with a new, much higher, base price for gold. Since the U.S. is no longer a factor in the gold picture, Europeans are now free to peg their currencies to gold valued at any price they care to set.

Q...Why didn't President Nixon simply devalue the dollar?

A...Because he works on the principle that the easiest way is the best way. The statesman-like procedure would have been to come out and tell the American people that we are no longer competing in world market, that the U.S. is in economic trouble, that the dollar is toppling, that our April-May-June trade deficit (\$5.8 billion) was the worst in American history, that the dollar was "on the floor" on all international monetary exchanges, and that the U.S. must now face a period of "blood, sweat and tears". Mr. Nixon might have said that he was calling a world conference to devalue the dollar in terms of gold, that the U.S. was going on the gold standard, and that the U.S. was going to enter a new period of increased productivity, lower government spending, lower taxes, and perhaps even lower wages and prices. All in all, I thought it was both astounding and dishonest that Mr. Nixon never mentioned the fact that the U.S. was in any way responsible for its own troubles.

Instead, Mr. Nixon talked about "international speculators", he embargoed gold, he said the dollar was no longer as good as gold, and he threw the whole monetary problem on our creditors. Of course it all mounted to an actual devaluation, but the U.S. never took responsibility for it. Responsibility was shoved on the rest of the Free World, and that's where it rests today.

Q...How can the U.S. get away with the 10% import surcharge?

A...The U.S.'s exports are only a small percentage of its total GNP. But to most foreign nations, their own exports (particularly to the U.S.) are a large part of their GNP. In other words, they must export to survive. Thus the U.S. is attempting to use the pressure of its huge markets to force what it wants. Personally, I feel that one repercussion of the U.S. policy will be that Europe will turn increasingly towards opening trade with Russia and China. In business, if one customer gives you a hard time, you turn to others.

Q...Will foreign nations "do anything" about the 10% surcharge?

A...This tax is a most serious imposition to foreigners. The U.S. is the world's biggest market, and I expect that foreign nations may cut their prices in order to ship goods into the U.S. at competitive prices. This will cut sharply into profits of foreign corporations, and it is no accident that Japan's stock market sustained its greatest loss in history (with many growth stocks dropping 20% in a day) on the news of President Nixon's measures.

Q...Why did the market take such a big jump following President Nixon's address?

A...Undoubtedly, a good deal of the April to August decline in the market was based on the bearish outlook for the dollar and the uncertainties brought on by continued inflation and the Administration's "see no evil, hear no evil" stand on the economic situation. Once the President spoke, the uncertainty was over, and regardless of whether the measures prove good or bad, the Administration did take a position. I think the position is unworkable, but the market will have to make its judgment on that in the course of time. The first reaction was relief, and this is a very common reaction for the market following a long period of decline and puzzlement.

Q...What will happen to the dollar now?

A...The dollar is now another floating currency, the currency of a nation which must put up barriers to protect its industry from foreign competition. The dollar will trade on the free markets of the world the same as any other currency, and hard heads and sharp pencils will determine each day what it is worth. By embargoing gold, the U.S. has "stuck" its European creditors with a mountain of greenbacks which counts upwards of \$45 billions. Supply and demand will determine the dollars worth, and with a European supply of over \$45 billions, I expect steady pressure as sellers of dollars unload their holdings at what the market will bring. Obviously, the lower the dollar sinks the more dollars it will take to purchase goods (not even considering the 10% tax on foreign goods). This will mean that foreigners will find it harder and harder to sell to the U.S. and the overseas boom, in my opinion, is now over.

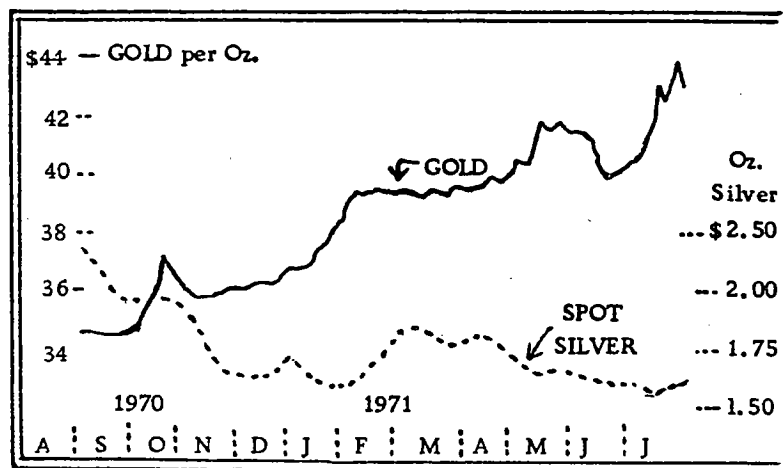
Q...How will the new measures affect the Communist nations?

A...I would imagine that Europe and Spain will now turn with increasing urgency to China and Russia as potential world markets. Japan is already rushing headlong to build up its trade with China. The U.S. gold embargo also provides both China and Russia with the "golden opportunity" (literally golden) of establishing convertible gold-backed currencies of their own, and thus meeting the U.S. in competition with currencies which ultimately could prove more desirable than dollars.

I have long disagreed with those who believe that Russia and China are planning to beat the U.S. militarily. Look how carefully they both stayed out of Vietnam. The coming great battle is going to be an economic one. With a fiat (non-gold backed) currency, with high prices and inflation held back only with controls, the U.S. is in a poor position to take on what amounts to the rest of the populations of the world.

Page 6 Q...How do you think the future of the Free World will be affected by President Nixon's new measures?

A...The whole Vietnam War was ostensibly an attempt to halt the spread of Communist influence. Well, to my mind, the fall of the dollar will prove to be a far greater disaster than our Vietnam adventure. For instance, Asian expert Edwin Reischauer stated that if we did not warn Japan of the 10% surcharge, it amounted to "...almost a declaration of trade war." He further noted, "Our important relation in Asia is Japan, not China. And it is now clear that China does not want the U.S. to continue such a close relationship with Japan. So in the next 10 years the most important thing to watch is the China-Japan relationship, not the U.S.-China relationship".



On August 17, John Allen May, the Christian Science Monitor's London correspondent polled leading British experts on what changes lie ahead. I have carried at the right a section of that article.

NOTE: My apologies to C.V. Myers of Myers Finance Review. Much of the information in Letter 502 regarding ADR's stemmed from Mr. Myer's original research and credit was inadvertently omitted.

MUSINGS: I believe that we are entering an entirely new era. For 200 years Americans have been battling external forces, solving external problems. How to survive as a nation, how to expand the country, how to produce, how to, how to, how to. Go through any magazine rack or bookstore and you'll note countless "how to" books; everything from how to soup up your hot rod to how to beat the horses.

I grew up during the Great Depression, and the key during those years was how to survive. During the 1940's it was how to win the war, and I was a bombardier with the Air Force in Italy during those dark days. Then in the 1950's it was how to get back to business as usual, and how to buy a house and two cars. When the 1960's came in it was how to enjoy prosperity, and how to get the "Soaring 60's" soaring even more. And our kids, they were starting to kick up a fuss and ask what it was all about. So it was how to straighten the kids out during the early 1960's.

Then during the mid-1960's and towards the late '60's it was how to hold America together, and what the devil was going on? And the forces of "control" were screaming for bigger military budgets and stop the long-hairs and don't let them see "Hair", and stop everybody from undermining the American ideals. Law and order became the name of the game to my generation, and it became a hated slogan to most youngsters under 25. Because they had grown up hearing about law and order, and they looked around at Washington and at the slums and at Vietnam and at their public schools and they decided that if that was law and order, they didn't want it.

And I've been pondering this whole problem for months and months, and a few nights ago my wife came up with most of what I believe is the solution. The battle coming up is going to be internal, not external. We've learned how to get to the moon and how to conquer most diseases and how to build sportscars and how to grow catfish in special cages. But we haven't learned how to give up the battle for control, how to listen to our friends and our families. And nations haven't learned how to listen to each other.

Here it is, 2000 years after the birth of Christ and we haven't learned to listen to ourselves, our own emotions, our own needs. Who says we need all the things we kill ourselves to get, the swimming pools, the expensive apartments, the \$10 restaurant meals? Who are we listening to, the external world of "shoulds" or our own intuition, our "inner voice", our internal self? I'm stating flatly that most people spend 90% of their time reacting to what the world thinks they should do, not what they intuitively want to do. No wonder the world is such an angry, unsatisfied place. And those are the seeds of what the new era is all about.

London

The American dollar's present troubles mark the start of a process of fundamental change some of the most acute financial experts here believe.

The process is likely to be complex. But these, say the London experts, are likely to be some of its components:

- The end of the "Bretton Woods era" of fixed and planned exchange rates.

- The end of the "GATT era" of multi-lateral trade liberalization. (GATT is the General Agreement on Tariffs and Trade. It has assumed organizational form and is headquartered in Geneva.)

- The end of the "dollar era," in which the United States dollar has been the one fixed star around which lesser currencies have revolved.

- The end of the "stock-market era," in which ordinary industrial stocks have been the accepted and almost automatic hedge for savings against inflation.

- The end of the "era of growth" for the Western industrial economic system as a whole, at least as that "growth" is measured today.

Also involved, it is said, are fundamental changes in the world financial power structure—immediately among the United States, Europe, and Japan, and in the longer term, possibly, among the West, the Soviet Union, and Communist China.